The Management University of Africa

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POST GRADUATE UNIVERSITY EXAMINATIONS

SCHOOL OF MANAGEMENT AND LEADERSHIP

EXECUTIVE MASTER OF BUSINESS ADMINISTRATION

EMBA 501: FINANCIAL MANAGEMENT

DATE: 4TH AUGUST 2016

DURATION: 3 HOURS

MAXIMUM MARKS: 60

INSTRUCTIONS:

1. Write your registration number on the answer booklet.
2. **DO NOT** write on this question paper.
3. This paper contains **FOUR (4)** questions.
4. Question **ONE is compulsory.**
5. Answer any other **TWO** questions.
6. Question **ONE** carries **30 MARKS** and the rest carry **15 MARKS** each.
7. **Write all your answers in the Examination answer booklet provided**

QUESTION ONE

a) The board of directors of Masii Limited is divided on whether to adopt a high or low dividend payout policy. One of the directors has quoted the 'dividend discount model' as proof that the 'higher the dividends, the higher the share price.' Highlight two arguments for and against a high dividend payout policy. **(4 marks)**

b) Goldstar Manufacturing Limited is evaluating an investment opportunity that would require an outlay of sh.100 million. The annual net cash inflows are estimated to vary according to economic conditions.

Economic conditions	Probability	Cash flow Sh. million
Very good	.10	35
Good	.45	28
Fair	.30	24
Poor	.15	18

The firm's required rate of return is 14 percent. The project has an expected life of six years. Compute the expected net present value (NPV) of the proposed investment. **(6 marks)**

c) Juma Company Ltd Which is effectively controlled by the Juma family although they own only a minority of shares, is to undertake a substantial new project which requires external finance of about Sh.400 million, leading to a 40% increase in gross assets. The project is to develop and market a new product and is fairly risky. About 70% of the funds required will be spent on land and buildings. The resale value of the land and buildings is expected to remain equal to or greater than, the initial purchase price. Expenditure during the development period of the first 4 to 7 years will be financed from other revenue of Juma Company Ltd. This will have a consequent strain on the company's overall liquidity.

If, after the development stage, the project proves unsuccessful, then the project will be terminated and its assets sold. If, as is likely, the development is successful, the project's assets will be utilised in production and the company's profits will rise considerably. However, if the project proves to be very successful, then additional finance may be required to further expand the production facilities. At present, Juma Company Ltd is all equity financed.

The financial manager is uncertain whether he should seek funds from a financial institution in the form of an equity interest, a loan (long or short term) r convertible debentures. Describe the major factors to be considered by Juma Company Ltd in deciding on the method of financing the proposed expansion project. **(10 marks)**

d) Identify and explain three methods of handling risks in capital budgeting. **(10 marks)**

QUESTION TWO

a) What assumptions must be made in deriving the Capital Asset Pricing Model (CAPM)? **(5 marks)**

b) Jabali Ltd. is a quoted company which is financed by 10,000,000 ordinary shares and Sh.50,000,000 of irredeemable 8% debentures. The market value of the shares is Sh.20 each ex-div and an annual dividend of Sh.4 per share is expected to be paid in perpetuity. The debentures are considered to be risk-free and are valued at par.

Mr. Jabali the managing director of the company is wondering whether to invest in a project which cost Sh.20 million and yield Sh.3.8 million a year before tax in perpetuity. The project has an estimated beta value of 1.25. The return from a well-diversified market portfolio is 16%. Compute the weighted average cost of capital of the company. **(5 marks)**

c) The Minister for Finance has stated that he wants to put a limit to the Public Sector Borrowing Requirements. What difficulties and economic problems are likely to arise due to this? **(5Makrs)**

QUESTION THREE

a) For each of the companies described below, explain which one you would expect to have a medium, `high or a low dividend payout ratio:

i. A company with a large proportion of inside ownership, all of whom are high income individuals. **(2 marks)**

ii. A growth company with an abundance of good investment opportunities. **(1 mark)**

iii. A company experiencing ordinary growth, has high liquidity and much unused borrowing capacity. **(2 marks)**

iv. A dividend-paying company that experiences an unexpected drop in earnings from the trend. **(2 marks)**

v. A company with volatile earnings and high business risk. **(2 marks)**

b) Highlight the limitations of the following methods of dealing with risk in capital budgeting:

(i) Simulation analysis. **(3marks)**

(ii) Sensitivity analysis. **(3 marks)**

QUESTION FOUR

Bara Ltd. is contemplating a bid for the share capital of Pwani Ltd. with an intention of buying the whole company. The following data for the two companies have been provided.

	Bara Ltd.	Pwani Ltd.
Number of shares	3,000,000	8,000,000
Share price	Sh. 150	Sh. 30
Latest equity earnings	Sh. 675 million	Sh. 80 million

After acquisition, Bara Ltd. intends to sell a division of Pwani Ltd. which accounts for Sh.20 million annually in equity earnings. The division does not form part of the core business of the intended group. The division has a current market price of Sh. 50 million.

Bara Ltd.'s management believes that by introducing better management, earnings of Pwani Ltd. could be permanently increased by 25% although the price/earnings multiple will remain the same. To avoid duplication, some of Bara Ltd.'s own property could be disposed of at an estimated price of Sh. 130 million. Rationalisation costs are estimated at Sh. 100 million, these comprise retrenchment and legal costs among others.

Required:

(a) Highlight the advantages of growth by acquisition. **(5 marks)**

(b) Calculate the effect on the current share price of each company, all other things being equal, of a two for ten share offer by Bara Ltd., assuming that Bara Ltd.'s estimates are in line with those of the market. **(10 marks)**